

Comments on “The Blueprint for U.S. Financial Competitiveness”

Richard J. Hillman

Managing Director

Financial Markets and Community Investment

U.S. Government Accountability Office

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I'd like to thank Peter Wallison for the invitation to be here today to comment on the “Blueprint for U.S. Financial Competitiveness.” The report, based on the deliberations of a distinguished commission responds to a charge from the Financial Services Roundtable to propose ways to reform the regulation of financial markets and institutions to ensure the continued vitality of the U.S. economy, and to the challenge that Treasury Secretary Paulson issued to consider a more principles-based approach to financial regulation.

At its core, the report argues that “With the accelerating expansion of global markets and competition it appears... that we have reached a ‘tipping point,’ where the inability of our current legal and financial regulatory system to adapt to new global methods of regulation is putting the competitiveness of U.S. firms at risk...[and] it also appears to be increasingly less effective in adequately serving and protecting consumers of financial products as well as fully supporting the stability of financial markets.” (p. 1) One of the report's key recommendations is the development and enactment of a set of “guiding principles” for financial regulation to deliver more balanced, consistent and predictable outcomes for financial institutions and their customers.

At GAO, the Government Accountability Office, we have been addressing similar questions over a number of years. For example, we have examined the regulatory systems in several other major industrial nations and, in 1996, recommended ways to simplify bank oversight in the United States in accordance with principles for effective supervision. Among the principles for an effective supervisory system that we then identified were

- consolidated and comprehensive oversight at the holding company level
- regulators that are independent from undue political pressure, balanced by appropriate accountability and adequate congressional oversight,
- consistent rules, consistently applied for similar activities,
- enhanced efficiency and as low a regulatory burden as possible consistent with maintaining safety and soundness.

In 2004, we recommended that Congress consider ways to improve the federal financial regulatory structure, particularly for oversight of the largest, most complex, internationally active firms. We found that the strength and vitality of the U.S. financial

services industry demonstrated that the regulatory system had not failed, but that fundamental changes in the industry—consolidation and conglomeration, convergence in product offerings, and increased globalization of financial institutions and markets—prompted a need to reassess the regulatory structure. We noted that Congress had created mechanisms for the agencies to coordinate their activities, and that the agencies themselves had undertaken actions to collaborate. We concluded that “the sheer number of regulatory bodies, their underlying competitive nature, and differences in their regulatory philosophies will continue to make the sharing of information difficult and true coordination and cooperation in the most important or most visible areas problematic as well.”¹ We did not recommend a specific change in the regulatory structure, but identified four options and discussed the pros and cons of each. These included consolidating regulatory agencies within functional areas, moving to a regulatory structure with specialized safety and soundness and consumer protection regulators, combining all agencies in a single financial regulator, or creating a new agency or authorizing an existing agency to be the supervisor of large, complex, internationally active firms while leaving the rest of the regulatory system in place.

Most recently, in response to a mandate in the Financial Services Regulatory Relief Act of 2006, we issued a report on October 12 that summarized many of our key conclusions and recommendations in prior reports.² In developing that report, Comptroller General David M. Walker convened a Forum bringing together a number of experts, including Peter Wallison and Rick Carnell, to consider many of the issues also addressed in the Roundtable’s report we are addressing today. We learned a great deal from that panel. My comments on the Roundtable report, and its recommendation for “guiding principles,” are based on GAO’s October 12 report and on other prior GAO reports. I have brought several copies of that report, which, with our other reports, is also available on our web site www.gao.gov.

The Roundtable’s report calls for “better, more effective regulation based upon guiding regulatory principles and greater prudential regulation across the entire financial services industry.” (p. 5) The financial regulators would be required to develop “Regulatory Action Plans” to implement these goals, reviewing regulations to ensure that their outcomes are consistent with the principles and achieve desired outcomes. The report also calls for the President’s Working Group to be expanded and statutorily charged with overseeing the implementation of these guiding principles, as well as serving as a forum for regulatory coordination. The PWG would report annually to Congress on progress toward implementing the “guiding principles” through the regulatory action plans.

Our reports have identified the importance of clear and consistent goals for financial regulation, putting us on common ground with the Roundtable report’s advocacy for “guiding principles.” Together with many of the participants in the Comptroller General’s Forum, however, we see greater promise in developing principles or goals for the

¹ GAO, *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure* (GAO-05-61, Oct. 6, 2004), p. 19.

² GAO, *Financial Regulation: Industry Trends Continue to Challenge the Federal Regulatory Structure* (GAO-08-32, Oct. 12, 2007).

financial regulators than in promulgating principles to guide industry behavior. Our October 12 report restated the goals we had identified in 1996, adding transparency in rulemaking, commitment to consumer and investor protection, and ensuring safety and soundness. Additionally, the International Monetary Fund, in its most recent Article IV report on the United States, also suggested consideration of a common set of regulatory principles.

Like the members of the commission that wrote the Roundtable report, we have looked at the United Kingdom's principles-based regulatory approach as a possible model for the United States. As a number of participants in the Comptroller General's Forum noted, the UK approach establishes principles for its regulatory agency, the Financial Services Authority (FSA), as well as principles for financial services providers. FSA does retain rules—Callum McCarthy, the FSA chairman, noted earlier this year that FSA has a “very large rule book,” with 8,500 pages of rules and guidance. FSA does acknowledge the difficulty of balancing principles and specific rules. There is a debate whether principles to guide the industry would be sufficient in the United States, although there appears to be increased belief that clearly stated, consistent principles or goals for regulators would be appropriate.

FSA explains that its “approach to supervision will rely increasingly on principles and outcome-focused rules rather than detailed rules prescribing how outcomes must be achieved,” giving firms “increased flexibility in how they deliver the outcomes we require.”³

Although principles for the industry could prove useful for the United States, they may not be enough, since they cannot provide industry with the same safe-harbor assurance of compliance that detailed rules do provide, nor provide consumers with sufficient assurance that those violating the rules can and will be prosecuted. While I don't think that many people would take exception to FSA's principles for business, it remains an open question how these standards for business would be interpreted and applied in the legal and regulatory system of the United States.

While the recent Northern Rock episode warns that there are no guarantees that the UK's approach ensures universal success (and FSA officials have repeatedly warned that “zero failures” is not a realistic expectation), our work indicates that clear and consistent goals for financial regulators could contribute to more effective financial regulation in the United States. Today, the federal regulatory agencies have goals and missions that, while broadly similar, differ in ways that limit their effectiveness. Several of our recent reports, as well as the Roundtable report, provide examples of this.

The Roundtable report, for instance, noted that three separate regulators are responsible for consolidated supervision of different types of holding companies, finding that the Federal Reserve, Office of Thrift Supervision (OTS), and Securities and Exchange Commission (SEC) “each has a different mandate, a different regulatory philosophy, and a different approach to regulation.” (p. 40) In our March 2007 report on consolidated

³ FSA, *Principles-based Regulation: Focusing on the outcomes that matter* (April 2007), p. 2.

supervision, we found that these agencies could develop more specific objectives, strategies, and performance measures for their consolidated supervision programs, and that they had opportunities to coordinate their activities more consistently and systematically.⁴ This is important for two key reasons. First, with the advent of SEC's consolidated supervised entity program, several large financial institutions fall under both SEC and OTS supervision at the holding company level, but the two agencies were not working to ensure consistent supervision. Second, with the trends of increased conglomeration and convergence in product offerings, there were no assurances that firms providing similar services received consistent supervisory treatment.

Collaboration between the banking agencies and SEC has been hindered by cultural differences and concerns about sharing information, a point that we have made in several reports. SEC's enforcement orientation differs significantly from the banking agencies' more prudential orientation. The banking agencies publicize their examination procedures, for instance, using that as a way to provide bank management with supervisory guidance on what constitutes safe and sound operation. SEC, historically, does not publicize its examination procedures, explaining that doing so might hinder enforcement actions. (SEC, however, generally does explain violations in much greater detail than the banking agencies in announcing enforcement actions.) Officials at the banking agencies have told GAO that they are often reluctant to discuss some issues with SEC, fearing that doing so might trigger an investigation while the banking officials are working to resolve the issue in a manner that does not compromise safety and soundness. (These officials did say, however, that they do make immediate referrals to SEC when they become aware of a potential securities law violation.)

I am happy to see that all three agencies have taken actions consistent with the recommendations we made in our report on consolidated supervision. OTS and SEC have advised us that they have begun to address issues of shared jurisdiction over several institutions that are both thrift holding companies and consolidated supervised entities, for instance. SEC has internally reassigned responsibilities for the testing and supervision components of the CSE program with the intent of strengthening its prudential supervision, and OTS has proposed changes in its supervisory approach for holding companies to more explicitly focus on the companies' risk management practices and better align its approach with that of the other agencies. SEC's actions, in particular, may be relevant to several of the Roundtable recommendations regarding prudential supervision, particularly 2D regarding "SEC communication and coordination."

Similarly, the Roundtable report found that the Basel II process illustrated the challenge of rulemaking by multiple agencies: "Each agency brought a slightly different mission and objective into the rulemaking process, and these differences were reflected in the range of changes proposed to the framework" after the final quantitative impact study. In our February 2007 report on the Basel II framework, we reached a similar conclusion,

⁴ GAO, *Financial Market Regulation: Agencies Engaged in Consolidated Supervision Can Strengthen Performance Measurement and Collaboration* (GAO-07-154, Mar. 15, 2007).

finding that differences among the regulators led to increased uncertainty about Basel II.⁵ In particular, we reported that “the differing perspectives the regulators bring to the Basel II negotiations make it difficult for them to explicitly define the criteria they plan to use to judge Basel II’s success.”⁶

GAO’s reports, particularly those on consolidated supervision and Basel II, in our view, provide support for a theme that plays broadly through GAO’s reports, that clearly stated goals, consistently applied, provide a strong basis for effective management of government programs and an effective means to ensure their accountability. Further, we have repeatedly reported that no single agency has the authority to identify and address issues in the financial system as a whole.

In these regards, our conclusions and recommendations are consistent with the Roundtable’s report. The goals that we suggested in our October 12 report do differ somewhat from the guiding principles recommended in the Roundtable’s report, although some of the differences may be more semantic than substantive. Rather than debate those differences, I’d look at the two sets of goals or principles, together with FSA’s principles and the Basel Committee on Bank Supervision’s “Core Principles” as some of the inputs into the necessary Congressional and national debate on what goals should guide financial services regulation in the 21st Century.

While our work on financial regulation is generally consistent with the Roundtable’s recommendation for “guiding principles,” questions remain on how best to implement those principles. The Roundtable report, in its detailed discussion of its recommendations, advocated expanding the President’s Working Group (PWG) to include the head of each “national financial regulatory authority” as well as “individuals with expertise in state banking, insurance, and securities regulation as appropriate.” (p. 69) While we have reported that no single agency has the authority to monitor the ability of regulators to meet their objectives on an ongoing basis, it is not clear whether the PWG, even if it were expanded and given statutory standing, would be able to promote the needed consistency of regulation. Our 2000 report on the PWG found, the Group, as currently constituted, was not well suited to orchestrate a consistent set of goals or objectives that would direct the work of the different federal financial regulatory agencies.⁷ Agency officials involved in the PWG said that it functioned well as an informal coordinating body. However, the agencies remain separate agencies. In the current PWG, the Federal Reserve, SEC and Commodity Futures Trading Commission (CFTC) are all independent agencies. Expanding the PWG to include the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and OTS would not resolve the issue. FDIC is an independent agency and, while OCC and OTS are under Treasury’s umbrella, they retain considerable independence from Treasury in their regulatory and supervisory decisions. Clearly, Treasury has a role to

⁵ GAO, *Risk-based Capital: Bank Regulators Need to Improve Transparency and Overcome Impediments to Finalizing the Proposed Basel II Framework* (GAO-07-253, Feb. 15, 2007).

⁶ GAO-07-253, p. 76.

⁷ GAO, *Financial Regulatory Coordination: The Role and Functioning of the President’s Working Group* (GAO/GGD-00-46, Jan. 2000).

play, but has to do so in a way that guards against even the perception of undue political influence. (Both we and the Basel Committee have identified independence from undue political influence as a principle for a system of effective financial regulation.)

As an alternative way to promote consistent and effective regulation, we have recommended that Congress reconsider the federal financial regulatory structure. GAO has also identified the need to modernize the federal financial regulatory structure as one of the key challenges that the nation faces in the 21st century. While the regulatory structure alone cannot ensure achievement of agency goals—agencies also need the right people, tools, and policies and procedures—the structure can hinder efforts to provide consistent and effective regulation that protects consumers, enhances the delivery of financial services, and meets the needs of the nation for strong and effective financial markets.

We recognize, and our reports detail, that the options we identified for consideration in modernizing the federal financial regulatory structure have both strengths and weaknesses. For instance, creating a single regulator, like FSA, would provide a structure with a single, consistent set of goals, but ensuring the accountability of such a large agency to consumers or industry would be a significant challenge. Many, if not most, of the participants at the Comptroller General's Forum warned that such a consolidation would result in an unwieldy agency, and everyone is aware of the difficult start-up for the Department of Homeland Security. Another alternative, charging a single agency with oversight of large, complex firms, could provide consistent regulatory treatment for those firms and thus the majority of assets in the financial system. It would also enable the agency to identify and respond to issues that cross current regulatory agency boundaries. However, it might be difficult to find and maintain an appropriate balance between the interests of the large, internationally active firms and smaller entities; this option, further, might add another agency to a regulatory system that already has many agencies. While recognizing the challenges to overcome the weaknesses of the current structure, however, we continue to believe that a modernized regulatory system is essential.

To conclude, our work at GAO is generally consistent with the Roundtable report's recommendations for guiding principles for financial regulation. Given the dramatic changes in the financial services industry over recent years, we have recommended that Congress reconsider the federal regulatory structure. A first step in any reconsideration of the federal structure should include an examination of appropriate principles for regulation. GAO is also encouraging a principles based approach in setting auditing standards for both government auditors as well as for standards setting processes of the PCAOB and the AICPA.

I also want to recognize the contribution that the Financial Services Roundtable has made in chartering this report. The federal financial regulatory agencies face challenges posed by today's dynamic financial environment: the industry's trends of consolidation, conglomeration, convergence, and globalization have created an environment that differs substantially from the environment prevailing when agencies were formed and their goals set by legislation. In particular, the fact that different agencies have jurisdiction over

large, complex firms that offer similar services to their customers creates the potential for inconsistent and inequitable treatment. Differences, even subtle ones, among the agencies' goals exacerbate the potential for inconsistency. Further, despite the changes posed by the industry's dynamic environment, clear accountability for addressing issues that span agencies' jurisdiction is not clearly assigned in the current system.

The commission co-chairmen wrote that the commission's goal for the "Blueprint" was that it would "serve as a starting point for a broader dialogue and constructive engagement with policymakers, regulators, and all interested parties to improve our legal and financial regulatory system and thereby enhance our ability to compete and serve consumers in national and international markets." (Message from Commission Co-Chairmen) The report comes as Treasury is also considering the design of the financial regulatory structure. No one can reliably predict the long-term outcome of this dialogue, but we believe it addresses an important challenge to our nation.